The Panama Papers: What Should Be Done?

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The Panama Papers are the latest major leak revealing the extent of tax avoidance among the world's rich and famous. How big is the tax evasion problem? Since it involves illegal behavior, it is hard to know. A recent estimate of the annual global costs of illegal tax evasion by the economist Gabriel Zucman was $200 billion, but this is probably too low since estimates for the U.S. alone range from $20 billion to $70 billion.

What might be done to reform this massive loss of revenue? In the case of the US, Congress has acted decisively. In 2010, it enacted the Foreign Account Tax Compliance Act (FATCA). Under FATCA, any foreign bank or other financial institution has to report to the IRS accounts held by American citizens and residents. The penalty for failure to comply is a hefty 30 percent tax on the foreign bank's U.S. income.

FATCA has real teeth, as the chorus of complaints by foreign banks and their governments shows. It also led to real developments. The IRS Offshore Voluntary Disclosure Program, which has netted more than $6 billion in taxes, is a child of FATCA. So are more than 100 "intergovernmental agreements" (IGAs) that the U.S. Treasury has negotiated with various countries. Under the IGAs, the foreign banks can disclose the information about U.S. account holders to their government, which can turn it over to the IRS. This avoids legal problems from the banks dealing directly with the IRS, which is illegal in most countries. Even Switzerland has signed an IGA.

In addition, more than 80 countries (including the U.S.) have signed a Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM), which envisages automatic exchange of tax information among the signatories, using a common reporting standard developed under FATCA.

But problems remain. First, FATCA itself is vulnerable because it can be avoided by using a foreign bank with no U.S. exposure. In addition, its disclosure obligations apply only to larger accounts and can be avoided by tax cheats opening smaller accounts at multiple banks. So secret offshore accounts are still possible, although the cost of tax evasion and the risk of discovery have increased. Second, these agreements depend on compliance by long-standing tax havens, an outcome that is far from certain. In addition, the IGAs require reciprocity from the U.S., and while U.S. regulations that require U.S. banks to collect the information for reciprocal exchanges have prevailed in initial court proceedings, they are still subject to vigorous judicial challenges.

Third, the U.S. has signed, but not ratified, MAATM, and it seems unlikely that it can be ratified in a Republican-controlled Senate.

Finally, the entire edifice rests on an uncertain foundation. For exchange of information to work, every single tax haven needs to cooperate, because otherwise the funds will flow to the non-cooperating havens. Total tax haven cooperation seems unlikely, to say the least, absent stiff sanctions that go beyond the U.S. 30 percent FATCA tax, such as a mechanism to cut off an offending tax haven's banks from the international wire-transfer system. In the past, world leaders have threatened sanctions against uncooperative tax havens, but never actually imposed them. Economists like to imagine universal solutions to the tax-evasion problem (such as the global tax on wealth proposed by Thomas Piketty, or the universal registry of financial assets advocated by Gabriel Zucman), but in the world we have, such solutions are utopian. Automatic universal exchange of information is likewise a nice ideal that may be implausible in practice.

There is an easier solution. The key observation is that funds cannot be invested in tax havens because they are too small (even Switzerland is a small economy if one ignores the banking sector). And they must be invested in the U.S., the EU, or Japan to avoid undue risk since most portfolio investors do not invest directly in emerging markets because of the political and economic risk.

Therefore, if the U.S., the European Union, and Japan were to agree to impose a tax on income flows to tax havens, the tax-evasion problem would largely be solved without the need for cooperation from the havens.

Using a 30 percent tax (the U.S. rate under FATCA) will do the trick. Investors will be faced with the choice of paying 30 percent on their gross interest, dividends, or capital gains, or declaring the income to their home jurisdictions and paying a net tax at that jurisdiction's rates.

What prevents this obvious solution from happening is that the U.S. is willing to aid and abet tax evasion by Europeans, while the EU is willing to aid and abet tax evasion by Americans. This reflects the political power of the rich on both sides of the Atlantic. (In contrast, Japan already imposes such a tax, demonstrating its feasibility.) What may change the status quo is that both sides have come to realize that U.S. residents can pretend to be Europeans, and EU residents can pretend to be Americans, widening the incidence of tax evasion in both. To stop the tax cheating, the EU is willing to impose anonymous withholding taxes on foreign account-holders; even Switzerland entered into such an agreement with the U.K. The U.S. should go along. Importantly, given likely Republican control of Congress, no change in law is necessary: The U.S. tax code already provides that withholding taxes can be imposed on payments to countries that do not have effective exchange of information. The Obama administration could apply this provision tomorrow if it had the political courage to do something about tax evasion.

If nothing is done about the tax evasion problem, the rich will continue to evade the progressive income tax. If that happens, ordinary middle-class taxpayers in the US and in Europe will be reluctant to pay their taxes. The income tax system is built around voluntary cooperation; if most citizens refused to cooperate, the tax authorities could not force them to do so. As the Greek experience has recently demonstrated, once a tax culture of non-payment is established, it is very hard to change. We need to do something about tax evasion before it is too late.

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